

## Alert

### Secured Lender Primes Earlier Federal Tax Lien in Fourth Circuit Split Decision

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The U.S. Court of Appeals for the Fourth Circuit, on Oct. 31, 2014, held in a split decision that a lender's unrecorded lien primed an earlier unrecorded federal tax lien on a Chapter 11 debtor's real property. *In re Restivo Auto Body, Inc.*, 2014 WL 5488166 (4<sup>th</sup> Cir. Oct. 31, 2014) (2-1). Relying on "Maryland[s] common law ... doctrine of equitable conversion," the court reasoned that the lender was entitled "to the same protections as a [good faith] purchaser for value who takes title free and clear of all subsequent liens regardless of recordation." *Id.* at \*2. The dissent, however, argued that federal law governs "the priority of federal tax liens" and that the debtor taxpayer had no "unencumbered title to ... give" the lender. *Id.* at \*13. As a result, in the dissent's view, the lender's asserted liens were junior to the earlier federal tax lien and the majority erred by applying "state law to determine the priority of the IRS's tax lien to the property." The priority of a federal tax lien, the dissent insisted, "is determined solely by federal law." *Id.* The case reassures secured lenders unaware of a borrower's preexisting tax lien, for it protects them against the government's nondisclosure.

#### Relevance of the Case

A secured lender will always seek to protect itself against competing lienors, such as when the federal government asserts a claim for unpaid taxes. It will routinely record its security interest as soon as its borrower signs a security agreement or mortgage. Any delay in recording may enable an intervening secured lender, judgment creditor or bankruptcy trustee to prime the earlier lender. In *Restivo*, however, the lender delayed recording its lien by five weeks and was still able to prime the intervening recorded federal tax lien that had arisen months before the lender made the secured loan. Five federal judges in three different courts, though, disagreed on how to resolve this priority fight.

*Restivo* has relevance beyond the tax lien context. The Pension Benefit Guaranty Corporation ("PBGC") will obtain a lien on a debtor's assets to secure the payment of its claims arising from the termination of an underfunded pension plan. 29 U.S.C. § 4068(a). In a bankruptcy case, the PBGC lien will be treated as a tax lien. 29 U.S.C. § 4068(c)(2). Claims under the Federal Coal Act also have similar status. 26 U.S.C. § 9707(f).

#### Basic Federal Tax Lien Principles

Under federal tax law (26 U.S.C. § 6320-6344) (the "Tax Code"):

- A tax lien is created by the IRS's (a) assessment and (b) demand, and by (c) the taxpayer's failure to pay (§ 6321).

- A tax lien arises from the time of assessment (§ 6322).
- The creation of a tax lien does not require recordation.
- An unfiled tax lien is generally valid against the taxpayer and most third parties.
- A tax lien covers “all property and rights to property” belonging to the taxpayer at the time of assessment, plus all of the taxpayer’s after-acquired property (§ 6321).
- A tax lien is enforceable by taking and selling the taxpayer’s property (levy and sale) (§ 6330).
- A buyer of the taxpayer’s property before the IRS makes a tax assessment prevails (§ 6321).
- “Semi-Super” Priority: After a tax lien arises *but before the IRS files a tax lien*, the “purchaser” of the taxpayer’s property or “holder of a security interest” prevails; purchasers and security interest holders are protected from unrecorded tax liens (§ 6323(a)) (emphasis added).
- A filed tax lien, however, is valid against most subsequent purchasers.

### Facts

The following dates are critical in *Restivo*:

- The debtor failed to pay federal employment taxes in 2003-04, giving rise to a U.S. tax lien on all of the debtor’s assets on *Sept. 20, 2004*, after the IRS had issued a notice and demand for payment (emphasis added).
- The debtor borrowed \$1 million from the lender (“Bank”) on *Jan. 4, 2005*, six days *before* the IRS “filed notice of its [earlier] federal tax lien” and gave “the Bank a note and a deed of trust on two adjacent parcels of real property ... to secure repayment of the loan, but [the Bank] delayed in recording the deeds.” 2014 WL 5488166, at \*2 (emphasis added).
- In the meantime, “six days later, on *January 10, 2005*, the IRS filed notice of a federal tax lien against” the debtor “for unpaid employment taxes.” *Id.* at \*1 (emphasis in original).
- The Bank eventually recorded its deed of trust on *Feb. 11, 2005* (emphasis added).

The debtor later filed its Chapter 11 petition in April 2011. After the IRS filed a claim against the debtor for taxes, interest and penalties, the Bank sued the IRS in the bankruptcy court, seeking a declaratory judgment that its lien primed the federal tax lien.

### The Bank’s Legal Position

The Bank relied on a provision in Maryland’s Real Property law that “relates back a deed of trust’s effective date upon recordation to the date when the deed of trust was executed.” *Id.* at \*2. Under this reasoning, the Bank’s recording of its lien on Feb. 11, 2005 would relate back to Jan. 4, 2005 and thus prime the IRS lien, which was not recorded until Jan. 10, 2005. More important, the Bank also claimed a prior “equitable lien” under Maryland’s common law doctrine of equitable conversion.

### The Bankruptcy Court and District Court

The bankruptcy court held for the Bank, reasoning that its recorded lien had, as a matter of Maryland law, related back to Jan. 4, 2005, six days before the IRS had recorded its tax lien. The district court affirmed on the same ground. More significant is the district court’s further holding that the Bank’s lien would have primed the federal tax lien under Maryland law even if the Bank had never recorded its lien.

As the district court read Maryland's doctrine of equitable conversion, the Bank had the same protections as a good faith purchaser for value who would be able to take "title free and clear of all subsequent liens regardless of recordation." The district court specifically relied on Tax Code Section 6323(h)(1)(A), which gives the federal tax lien the status of a subsequent judgment lien "arising out of an unsecured obligation," which is subordinate to an earlier good faith purchase for value. *Id.* at \*2.

### **The Court of Appeals**

The Fourth Circuit reversed the district court's holding that Maryland law gave the Bank retroactive priority over the recorded federal tax lien, relying on Section 6323(h)(1)(A). Nevertheless, it affirmed the district court on the ground that Maryland's common law doctrine of equitable conversion gave the Bank an "equitable security interest in" the debtor's real property on Jan. 4, regardless of the Bank's failure to record its lien at that time. It reasoned that the Bank's interest became "protected ... against a subsequent lien arising out of an unsecured obligation" on that date, giving it "priority over the federal tax lien." *Id.* at \*1, citing Tax Code §§ 6323(a) and (h)(l).

### **Federal Law**

Federal law determines the priority of a federal tax lien, the court stressed. A federal tax lien will ordinarily prime a later arising lien under the established principle that "the first in time is the first in right." *Id.* at \*3. But the tax lien will not be valid against any later holder of a security interest until the IRS files notice of its tax lien. *Id.*, citing Tax Code § 6323(a). The existence of a "security interest" that will prime a federal lien turns on whether "the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation." *Id.*, citing Tax Code § 6323(h)(1)(A).

### **The Bank's Late Recorded Lien Did Not Relate Back**

The Bank argued, in reliance on Maryland case law, that its recording of its lien on Feb. 11, 2005 related back to Jan. 4, 2005, when the debtor had signed the deed of trust. Disagreeing, the Fourth Circuit held that the district court "misinterpreted § 6323(h)(1)(A) in ruling that [Maryland's statutory law] gave ... [the Bank] a prior security interest" because the Tax Code "explicitly" precluded "the application of a relation-back rule." *Id.* at \*7. The vague language of the relevant section "requires ... the evaluation of" the Bank's "security interest ... as of the date that notice of the federal tax lien was filed." *Id.* at \*6. Because the Bank "had not, as of that date [Jan. 10, 2005], recorded its" lien, "the relation back provision" in the Maryland Real Property statute did not yet apply. *Id.* In other words, the Bank's lien could only relate back to a prior time if the Bank had perfected (i.e., recorded) that lien at a point prior to the recording of the federal tax lien.

### **Maryland's Doctrine of Equitable Conversion Enabled the Bank to Prime Unrecorded Tax Lien**

The Fourth Circuit affirmed the district court, however, on the ground that the Bank had a prior "security interest," consistent with Tax Code Section 6323(h)(1)(A), by applying the Maryland "doctrine of equitable conversion." *Id.* at \*8. It agreed with the district court that "under Maryland law, ... the holder of an equitable title or interest in property, by virtue of an unrecorded contract of sale, has a claim superior to that of a creditor obtaining a judgment subsequent to the execution of the contract." Moreover, "the doctrine [of equitable conversion] applies to lenders whose interests are secured by mortgages or deeds of trust." *Id.*, quoting *Stebbins-Anderson Co. v. Bolton*, 117 A.2d 908, 910 (Md. 1955). In short, federal law (Tax Code § 6323(h)(1)(A)) makes Maryland law applicable, and under that law, "judgment liens are 'subject to prior, undisclosed equities.'" *Id.*, quoting *Wash. Mut. Bank v. Homan*, 974 A.2d 376, 389 (Md. Ct. Spec. App. 2009). Maryland law thus "protects equitable security interests against subsequent judgment-creditor liens." *Id.* at \*8.

Maryland courts “have repeatedly held that a land purchaser’s equitable title is superior to any judgment lien subsequently obtained against the seller.” *Id.* In addition, Maryland courts protect the “security interest of a purchaser regardless of the purchaser’s compliance with the recordation statutes,” which “protect only bona fide purchasers.” *Id.* at \*9. “Thus, a judgment creditor’s claim ‘is subject to prior, undisclosed equities’ ... .” *Id.*, quoting *Ahern v. White*, 39 Md. 409, 421 (1874). The Bank, as a good faith holder of a deed of trust, would be “entitled to the protections available to a good faith purchaser for value.” *Id.*, citing *Wash. Mut. Bank*, 974 A.2d at 396.

Moreover, reasoned the Fourth Circuit, Maryland is not unique. Both Texas and New York courts have held that a lender with a deed of trust primed a debtor’s subsequent judgment lien creditor. *Id.* at \*10.

### **Federal Law Makes State Law Applicable**

The Bank here took equitable title to the debtor’s real property when the debtor signed the deed of trust on Jan. 4, 2005, giving the Bank “priority over” any of the debtor’s later “judgment-creditor lienholders.” *Id.* Because the Tax Code subordinates a federal tax lien to a deed of trust “that has become protected ‘against a subsequent judgment lien arising out of an unsecured obligation,’” Tax Code § 6323 (h)(1)(A), the Bank’s “equitable security interest,” arising on Jan. 4, 2005, primed the later federal tax lien recorded on Jan. 11, 2005. *Id.* Regardless of when the federal tax lien rose, “Congress ... amended § 6323(a) to make unrecorded tax liens ineffective against holders of security interests ... .” *Id.* In short, the Tax Code “subordinates unrecorded tax liens to security interests, and it defines security interests according to their protection under state law against subsequent judgment liens.” *Id.*, citing Tax Code § 6323(h)(1)(A). Maryland law, too, confirmed that “recordation” of an equitable interest such as the one held by the Bank here “is irrelevant to the [equitable] doctrine’s application.” *Id.*

The majority of the Fourth Circuit panel rejected the dissent’s argument that “the IRS’s tax lien ‘was not a subsequent lien.’” *Id.* at \*10n. Instead, the majority held that the “Tax Code subordinates unrecorded tax liens to security interests” that are protected “under state law against subsequent judgment liens.” *Id.* at \*10, citing Tax Code § 6323(h)(1)(A).

The dissent accused the majority of mistakenly applying state law to determine the priority of the federal tax lien. In its view, the majority “blurr[ed] the line between the IRS and a judgment creditor and between a tax lien and a judgment lien without citing any precedent that allows it to do so.” *Id.* at \*13. The dissent stressed that there was “no judgment lien here. There is a tax lien. And its priority ... is determined solely by federal law.” *Id.* Because the federal tax lien “predates” the Bank’s lien, explained the dissent, it “arose and became protected at an earlier date” and was “not a *subsequent* lien.” *Id.* at \*14.

### **Comment**

The dissent was right about one principle: “the priority of federal tax liens is governed by federal law.” *Id.* at \*13. But that principle does not mean the federal government always wins or even that it should win in *Restivo*.

Federal law here gave the Bank a “semi-super priority” under Tax Code § 6323(a): A federal tax lien is not “valid against any purchaser [or] holder of a security interest ... until” the IRS files notice of its lien. Section 6323(h)(i) defines “security interest” to include “any interest in property ... for the purpose of securing payment ... .” That “security interest” exists when, among other things, it “has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation.”

Maryland law in *Restivo*, expressly made applicable by Tax Code Section 6323(h)(l), enabled the Bank to prime the unrecorded federal tax lien. See generally Steven R. Mather & Paul H. Weisman, 637-2<sup>nd</sup> T.M., *Federal Tax Collections Procedure – Liens, Levies, Suits and Third Party Liability* A-29–A-32 (2013), citing Treasury Regs. § 301.6323(h)-(l)(a)(2).

One commentator’s explanation, 13 years ago, of the federal tax lien priority shows why the Bank had to prevail in *Restivo*:

As a general rule, “first in time, first in right” prevails. The Federal Tax Lien Act of 1966 established the priorities of the Government as compared to other creditors, both secured and unsecured. IRC § 6323 sets forth the rules to apply in determining priority amongst creditors. It divides creditors into four classes.

1. The first level of creditor is those creditors who receive priority status only if their liens are perfected before the Notice of Federal Tax Lien is filed.
2. The second level of creditors is given “semi-super” priority status in IRC § 6323(c). They have limited priority over a perfected federal tax lien, *provided that their interests are created pursuant to a written agreement which is entered into before filing of the Notice of Federal Tax Lien, and is protected under local law against subsequent judgment lien creditors.*

....

The general creditor is the “man in the middle” in the federal collection process. Because of the lack of status, the general creditor must take steps to protect his or her interest. The Government knows that if it publicizes a taxpayer’s tax obligations by filing notice of liens, the taxpayer’s credit will evaporate and the chances of earning enough to pay off the tax obligation will be significantly impaired. *Therefore, it has been the practice of tax authorities to exercise forbearance in filing notices of lien in cases when there appears to be a reasonable possibility that the business can regain financial stability.* A general creditor is anyone who has not perfected their interest in the debtor’s assets, either by mortgage, security interest, or judgment. It has been contended that the IRS, assured in any event of a priority over general unsecured creditors, has preferred to induce them, by nondisclosure, to provide the financing that will improve the taxpayer’s chances of at least paying off the federal taxes. Taxpayers are first encouraged to borrow the money from an outside source before exploring other payment possibilities.

D. A. Schmudde, *Federal Tax Liens* 67-68; 73 (4<sup>th</sup> rev. ed. 2001) (emphasis added). In *Restivo*, the IRS may have failed to record its lien with the hope that a lender like the Bank would help the debtor regain its viability and pay its outstanding taxes.

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